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THE HOWE REPORT

President's Comment

by William B.P. Robson

Making the *Advantage Canada* Plan

Federal Finance Minister Jim Flaherty's Economic and Fiscal Update *late last year came with an important kicker — a five-point* Advantage Canada *economic plan. While the* Update's *fiscal projections garnered much of the attention, the five-point plan has much in it that, in the long run, could matter much more.*

Canadians concerned about our country's attractiveness as a place to work and invest — and the threat posed to our living standards by a poor showing on that score — have been looking forward to a blueprint for prosperity from the new federal government. Is the *Advantage Canada* plan something policy advocates, business people and others can pick up and run with?

An answer to that question needs to begin by noting that marshalling support for a program focused on long-term productivity and prosperity has long been a challenge for federal governments. Only policy wonks remember *Advantage Canada's* ill-fated counterparts in the early 1990s and early 2000s. Two related flaws afflicted those previous attempts to rally people behind a productivity agenda. One flaw was that these packages were too complex and heterogeneous to draw a large group of supporters all marching in step. The other flaw had to do with the banner under which supporters were expected to march — productivity growth. To economists and business people, those words promise that we will live better in the future at less cost in work, resources, and environmental stress. To the lay ear, productivity sounds like a short-term threat: next year, we will have to do more with less.

The *Advantage Canada* title shows that the government has done fresh work on the branding side. The document lists five advantages Canada should strive to achieve in the years ahead: a tax advantage from lower taxes on people and business investment; a fiscal advantage from debt reduction; an entrepreneurial advantage from regulatory streamlining and pro-competitive policies; a knowledge advantage from education and work training; and an infrastructure advantage from new investments in border and transportation facilities. These are important goals, and the language in which they are expressed — doubtless refined in focus groups — is clear and persuasive.

The substance of the plan, however, shows that complexity and multiple goals involving many different policies still impede consensus on clear priorities. Immediately after announcing its five goals, the plan describes four "core principles" for achieving them: focusing government; creating new opportunities and incentives for individuals; strategic government and public-private investments; and freeing business to grow and succeed. Five goals and four principles make a matrix of 20 cells! Even if some of those cells are empty, a matrix that big contains lots of room for confusion and conflict. So, to mix metaphors, deriving a workable blueprint for prosperity requires some cherry-picking.

Some of the strongest material in *Advantage Canada* deals with taxation. The document describes how high marginal

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by Finn Poschmann
Director of Research

A Taxing Test for Budget Rhetoric

— Does Action Follow Words?

In Ottawa and the provincial capitals, the first few months of the year mark decision time, as policymakers crystallize their fiscal choices in annual government budgets. Because budgets reveal governments' priorities — as shown by the quantity of dollars attached to them — they are centerpieces of public policymaking. One way to assess them is to compare what they say, in compelling rhetoric, and what they do in the form of policy initiatives.

Economists have come to hold heavy influence over budget rhetoric. This is quite satisfying of course, for economists, as budgets' language, particularly at the federal level, routinely refers to the important role that a competitive investment environment plays in creating fertile ground for growing productivity and wages, and greater prosperity for Canadians.

One mark of the economists' success, and a proud one from this Institute's perspective, is the prominence budgets now give to international and interprovincial comparisons of tax-friendliness to business, and in particular to the marginal effective tax rate (METR) on new business investment. For example, the federal vision statement released with the latest budget update, *Advantage Canada*, proposed by 2011 to "improve Canada's business tax competitiveness by establishing the lowest METR in the G7." As Bill Robson notes in his column nearby, this could be seen as part of a good and healthy branding strategy.

Tax policy touchstone: The notion of low tax rates applied to a broad and neutral tax base is a touchstone for most public finance economists, a goal to be achieved in the interest of maximizing potential economic performance. The extent to which the goal is achieved is arguably indicated by a low METR, evenly applied across industry sectors and business activities. However, as revealed in "Business Tax Reform: More Progress Needed," (Chen and Mintz 2006, http://www.cdhowe.org/pdf/ebrief_31.pdf), considerable variation across sectors remains, with the effective tax rates applying to investment in the communications or construction sectors, for example, far exceeding the effective rate in manufacturing.

In fact, federal and provincial budgets routinely include shopping lists of preferences, tax credits and rebates for selected investment vehicles, favoured industry sectors and regions and particular types of activity. The spring 2006 federal budget, like numerous Ontario budgets of years past, continued this exercise in "political economy," which entails a little-something-for-everyone, but few genuinely broad-based measures.

Signals to watch for: What should we look for in upcoming budgets as signals that governments are taking seriously the low-rate, broad-base tax policy goal? A lower statutory general corporate income tax rate is certainly part of the answer, and at the provincial level as well as the federal. Corporate taxable income can be shifted geographically, in search of a low-tax jurisdiction. For their part, provinces should recognize that they do not give up much, if any, direct tax revenue when lowering corporate rates relative to their domestic and international neighbours.

The international importance of a competitive statutory business rate became all the greater post-Halloween 2006, with the announcement of an end to the favourable treatment of income trust distributions to nonresidents and tax-exempt accounts. As a result, domestic equity's attractiveness to foreign and domestic investors will depend more than before on the general business tax rate.

The federal and provincial governments need also to think hard about the role of fiscal policy in turning investment in research and development into prosperity-improving processes and products. As Ken McKenzie commented in *Giving with One Hand, Taking Away with the Other* (http://www.cdhowe.org/pdf/commentary_240.pdf), favouring R&D activity, while imposing high taxes on the fruits of innovative activity and entrepreneurship, undermines the goal of promoting economic growth.

Again, the economist's message is about low tax rates applied to a broad tax base, rather than a splintered base. There is an ancillary message, which is that policies targeted at growth might involve improving the returns to success in innovation, rather than offering credits or preferential tax rates for favoured corporate structures, investment vehicles, or securities.

Complementary personal tax policies include relief on reinvested capital gains and more choice in lifetime savings vehicles, just for openers. This suggests that there are plenty of policy indicators to watch for, in upcoming federal and provincial budgets, that will offer evidence on how seriously governments take their economic policy rhetoric.

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Making the *Advantage Canada* Plan

Live up to its Name

effective tax rates erode the rewards for work by modest-income people, and commits to a federal earned-income credit to mitigate them. It acknowledges the obstacle that high average personal tax rates create to the attraction and retention of talent, and pledges to lower them. And it documents Canada's uncongenial environment for business investment, and highlights changes — in particular to provincial sales taxes on business inputs and to capital taxes — that would improve it.

A nice fiscal touch in the plan was the commitment to pass on further interest savings from debt reduction to Canadians, in the form of personal tax relief. This commitment adds about $1 billion annually to money explicitly identified in the Update as available for new measures. If the government can hold its near-term spending increases to the less-than-economic-growth benchmark outlined in the plan, the spring 2007 federal budget could deliver a larger tax-relief package than the *Update* suggested. On the negative side of the fiscal ledger, however, was a poorly judged debt target. The commitment to reduce "net" government debt to zero by 2021 is meaningless. It includes Canada and Quebec Pension Plan funds on the asset side without also taking account of the obligations of these plans. And it does not include other unfunded obligations such as government-employee pensions and health benefits.

The plan's vagueness on the subject of intergovernmental issues is also troubling. Some passages extol the virtues of recent increases in federal transfers for health and promise new funding for postsecondary education; others promise to limit federal spending in areas of provincial jurisdiction. Some passages appear to promise a richer equalization program and major new federal-provincial transfers; others talk about tax reductions. Critically, the *Advantage Canada* plan does not broach the kind of major reductions in Ottawa's tax take needed to make the provinces more self-sufficient — and accountable — or to sweeten the pot for provinces reluctant to reform the retail sales taxes that loom so large in Canada's current business-tax disadvantage.

Other elements in the plan's implicit matrix point in useful directions. With the exception of the renewal of the Bank of Canada's 2 percent inflation target, however, few of them are straightforward to implement. Federal governments have long talked about enhancing Canada's economic union — but Ottawa has few levers to bring the provinces in line. Worse, it hesitates to reform federal policies, whether in EI, tax policy or agricultural monopolies, that fragment the country. Bringing in more skilled immigrants and working to improve the labour-market experience of recent arrivals are worthy goals — but the political sensitivities and litigation that paralyze immigration policy are not about to disappear. The *Advantage Canada* documents rightly point out the benefits of openness to international trade and investment, and the corresponding need to invest in border infrastructure and security — but there are challenges in store. Maintaining and enhancing open borders means dealing adeptly with concerns about sovereignty, and resisting the temptation to divert infrastructure money into domestic pork-barreling.

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At least as many devils lurk in the details of the plan's commitments to competitive markets, modern competition policy, a 20 percent reduction in the burden of paperwork for businesses, and principle-based regulation. The regimes currently in place are products of many years of negotiation and adaptation. Enhancing the role of markets in such cases can bog down in wrangling over local zero-sum contests if no larger packages offer net wins to most of the players.

The task now confronting the government — and all of us motivated to enhance Canada's attractiveness as a place to work and invest — is to distill a workable agenda from *Advantage Canada's* implicit multi-cell matrix. The headline goals in *Advantage Canada* are important, and the language in which the Finance Minister expressed them was compelling. Getting from that document to a blueprint for action requires engagement and encouragement from everyone interested in a more productive and prosperous Canada. ■

by Duncan Munn
Vice President of
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New Year Brings New Friends

The Greek philosopher Epicurus famously said, "Of all the things which wisdom provides to make life entirely happy, much the greatest is the possession of friendship."

The New Year is a time to celebrate many things, and friendship is certainly one of the most important. Friendship takes on particular importance at the C.D. Howe Institute. The fresh ideas, unique insights and constructive criticism we receive from our members constantly challenge the Institute to remain relevant. We are poked, prodded and inspired to produce research whose quality and timeliness ranks with the very best.

In the rush of activity that characterizes a lean, nimble and ambitious think tank such as the C.D. Howe Institute, it is often difficult to recognize members in the fashion they truly deserve. But it is the tapestry of a thousand-and-one contributions, stitched together, that creates the fabric of the C.D. Howe Institute. To our long-time members, we remain humbled and thankful for your support and friendship. We take neither for granted and we work hard every day to earn your continued loyalty.

To our new members, a group which continues to grow for 2007, I welcome you to the Institute. Your friendship is important and valued.

New members, Sam Shaw of the Northern Alberta Institute of Technology (left) and Andrew Abouchar of Tech Capital Partners.

- Welcome to **Andrew Abouchar** of **Tech Capital Partners**. Thank you for your advice on cross-border tax issues.
- **BC Hydro**, your contribution to our competition policy conference was substantive and thoughtful.
- **Rad Latimer** and **Algoma Central**, we are honoured to have the support of an organization that has operated ships on the Great Lakes continuously since 1900.
- **Stephen Smith** of **First National Financial**, it is a pleasure to have an innovative financial services firm in our ranks. You join a strong complement of financial services firms who are members, including new member **Davis & Henderson**, a firm that has been serving the Canadian financial services industry since 1875 — welcome and thank you **Robert Cronin**.
- **Mr. J. Mark Lievonen** of **Sanofi Pasteur Limited**, thank you and welcome. We look forward to Sanofi's **Dr. Louis Barreto's** participation in our upcoming Roundtable on pandemic planning.
- We are pleased to have the support of former Molson's CEO and Toronto Port Authority head, **John Barnett**, now at **Benson & Hedges**.
- Welcome as well to **Sam Shaw** of the **Northern Alberta Institute of Technology**, a leader in technical training and applied education. Your support confirms the value of cooperation between the Institute and academia.
- Calgary is well represented by new members **Blair Albers** and **BJ Energy Services**. Welcome.
- **Rob Hinrichs** of the **Workplace Safety and Insurance Board**, thank you for your support and advice on intergenerational equity questions.
- **Robert Pletch** joins as a new individual member, demonstrating a strong personal commitment to policy.
- **Jack Mintz** and **Tom Kierans**: What an honour it is to have two former Institute presidents as new individual members.
- At press time, I'd like to acknowledge the support of two more new members: **Kenneth Finch** at **Kal Tire** and **Larry Berg** of the **Vancouver International Airport Authority**.